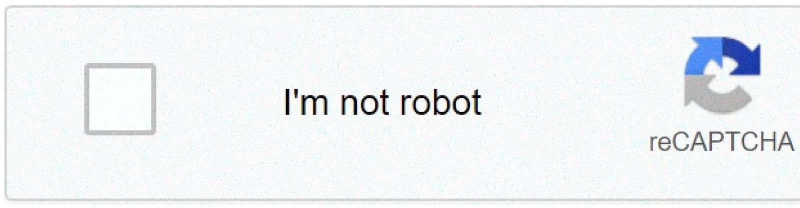

Private placement variable annuity

A variable annuity is an insurance contract designed to provide a regular source of income. The contractual agreement is between you and the sponsoring insurance company. You purchase your variable annuity, and the company invests your money in your choice of financial vehicles, which might include mutual funds, stocks and bonds. After a set period of time, you begin to receive payments of your initial investment and earnings. This might sound too good to be true, and many financial experts contend variable annuities have a plethora of problems. One of the primary complaints about variable annuities is the operating fees. Forbes reports that fees average at 2 percent, maxing out at 3 to 4 percent annually. SmartMoney contends variable annuity fees are at least 1 percent higher than the average mutual fund fees. Bottom line: You’re going to pay higher fees on a variable annuity than other investment vehicles. You’re also going to pay charges. The Securities and Exchange Commission warns that variable annuities come packed with charges. You’ll have to pay a surrender charge to cash out the annuity early. You’ll also have to pay a mortality and expense risk charge, just to make sure the insurance company is absolved of any risk associated with your annuity. There are also special features -- much like insurance riders -- that you can add on to your variable annuity, but they’ll cost you in extra charges. To rub salt in the higher fee and excess charges wound, the Internal Revenue Service does not bless variable annuities as traditional investment vehicles. Your gains within the annuity will grow tax-deferred, but you cannot take a tax deduction for your initial variable annuity contribution like you can for your traditional IRA contributions. In most cases, variable annuities receive no special tax treatment from the IRS, all gains will be taxed at your normal income tax rate and your heirs do not receive special tax treatment when they inherit your variable annuity upon your death; in other words, they’ll have to pay full taxes on your annuity if you’ve deferred them up to that point. Although a variable annuity is a contract with an insurance company, it is not really “insurance” in the traditional sense of the word. When investing in a life insurance policy, your heirs receive a predetermined lump sum upon your death, usually tax-free. If you die holding a variable annuity, your heirs will only receive the value of your account -- and be taxed on it to boot. If your variable annuity is in good standing upon your death, this might not be so bad. If the annuity has lost money since your initial investment, your heirs will inherit the loss, unless you purchase a special rider. In some cases, a variable annuity might pay off. If you live long enough to begin receiving your periodic payments, you’ve got extra income coming in monthly. This might work if you’re just looking for a few extra dollars a month to tinker with during your retirement. Overall, however, the variable annuity is not set up to provide you with the long-term investment and tax benefits that other investment vehicles allow, and that just might be the greatest variable annuity problem of all. Retirement benefits offered by employers and the government are subject to income limits that restrict the amount of money you can contribute each year. An annuity is a type of financial product you can buy privately with an insurance company that is not subject to income limits. You can buy an annuity with a single lump-sum payment or a series of payments, which entitles you to recurring income payments during retirement. A variable annuity is a type of annuity where the size of payments you receive varies based on the performance of underlying assets. When you buy an annuity, your contributions go into investments like stocks and mutual funds that can increase in value over time. A variable annuity lets you choose from a selection of investments and the income payments you receive in retirement depend on the growth of the investments you choose. By contrast, fixed annuities pay a specific dollar amount for each periodic payment and does not change over time. The primary advantage of variable annuities is the potential for high investment returns. If you manage to pick investments that perform well, your annuity payments could increase and exceed those that you might receive from a fixed annuity. Annuities also offer tax deferral of investment gains, so you don't pay tax on earnings your account generates until you receive funds during retirement. Investment gains generated by an annuity are taxable as ordinary income when you receive them. Since variable annuity payments depend on underlying assets, the value of your annuity can decline if investments don't perform well. Gains on investments you make on your own are generally subject to a maximum tax rate of 15 percent if you hold them longer than a year, but gains distributed from an annuity are taxed at your normal income tax rate, which could be as high as 35 percent. Variable annuities also tend to carry high fees that cut into gains and make it more difficult to come out ahead. It is possible to purchase an annuity with funds from a retirement account like a 401(k) or individual retirement account. Tax advantaged accounts like 401(k)s and IRAs already offer tax deferral, so you don't gain any additional tax benefit by holding an annuity within such an account. In addition, you have to pay income tax on the entire amount of annuity payment if you funded the annuity with pretax or tax deferred money. There are several different types of annuities, each designed to fill a different investment niche among investors. Variable annuities offer all the benefits of annuities in general, but they also enable you to earn investment income for both stocks and bonds. Much like target date funds, they represent something of a “fund of funds” offered by insurance companies. And like IRAs and other retirement plans, they also provide tax-deferred investment income, as well as income payouts once you reach retirement age.What are Variable Annuities?A variable annuity is an annuity contract offering investors an opportunity to earn higher rates of return on their investments than what they can get with fixed annuities. This is because while fixed annuities pay interest similar to certificates of deposit, variable annuities include participation in both the stock and bond markets.Just as is the case with other types of annuities, the money that you invest in a variable annuity accumulates on a tax-deferred basis. A variable annuity can also be setup to provide an income upon reaching retirement, or some other desired date. However unlike fixed annuities, variable annuities are not generally guaranteed, and will be largely dependent upon the performance of the sub-accounts where the money is invested.Sub-accounts are the insurance industry equivalent of mutual funds. They can invest in various types of stocks and bonds, depending upon the desired purpose of the investment. However the sub-accounts, unlike mutual funds and exchange traded funds, are usually not listed on public exchanges. They are investment units offered on a proprietary basis by individual insurance companies.Within a single variable annuity contract you can choose to invest in multiple sub-accounts, covering various asset classes. Since these sub-accounts are professionally managed, variable annuities represent “hands off” investments. Exactly which asset classes will be invested in will depend upon the income desired.Though variable annuities do not come with the guaranteed income offered by fixed annuities, they can actually provide a long-term return that is superior to fixed annuities, since it includes participation in the equity markets. This gives the investor in variable annuities an opportunity to both keep up with inflation, and even outpace it as a result of higher returns.On the flipside however is the possibility that the investments within the variable annuity will experience a prolonged period of poor performance. If that’s the case, the investor in a variable annuity could actually experience a loss of principal, resulting in a smaller income stream upon retirement.Variable annuities are long-term investments and have limitations on when you can withdraw money. They generally permit you to make one withdrawal each year. However, if the withdrawals are taken during the “surrender period” – the time during which a surrender charge applies – that charge will have to be paid upon withdrawal. The surrender period can last as long as 10 years. Once it expires, withdrawals can be made without incurring the charge.The Benefits of Variable AnnuitiesGuaranteed death benefit. This is a benefit that does not come with mutual funds or exchange traded funds. The death benefit ensures that your heirs will receive an amount equal to no less than your initial investment in the plan – and that’s even if the value of the plan declines due to market factors. The protection is provided through a mortality charge.Minimum rate guarantee. This is a rider that can be added to your variable annuity for an extra fee, that will ensure that you receive a minimum rate of return, even if the sub-accounts within your plan experience a loss. You can also add a similar rider that will provide a guaranteed minimum payout rate for when you begin making withdrawals. It similarly guarantees your payments despite a poor performance by the sub-accounts. Both riders are available with some variable annuities, but not all.Income tax deferral. As is the case with all annuities, though your contributions to the plan are not tax-deductible, the investment earnings within the plan are. That means that your variable annuity can grow from inception to retirement without any concern for tax consequences. And as is the case with all tax-deferred retirement accounts, any withdrawals made before you turn age 59 1/2 will be subject to ordinary income tax and the IRS early withdrawal penalty of 10%.Investments within the plan can be changed. Unlike a mutual fund, your investments within a variable annuity are not fixed. Since there are multiple sub-accounts to choose from, covering different asset classes, you can shift the investment mix within the plan. This can give you the opportunity to take advantage of different investment environments, as well as changes in your own investment needs, or to make adjustments based on your age.Lifetime income. One of the primary reasons people invest in annuities is to provide them with income that will cover the rest of their lives. This is obviously important when it comes to retirement income, as one of the biggest concerns of retirees is the prospect of outliving their money. An annuity can be established that will provide you with a fixed income for your entire life.Protection from creditors. In some states annuities are protected from the claims of creditors. If you are an occupation that is subject to the lawsuits – such as the medical profession – annuities, including variable annuities, can protect the assets within them from creditor claims.Are Variable Annuities FDIC Insured?One potential disadvantage annuities have is the lack of any sort of insurance coverage provided by the US government, such as FDIC insurance for bank deposits or the Securities Investor Protection Corporation (SIPC) coverage for brokerage accounts. However that doesn’t mean that you have a significant risk of loss of your account.Annuities are insured by the insurance company that issues them. And while there is a slight chance of an insurance company failing, it is an event that is very unusual in US history. You can reduce the chance of this happening by determining the financial strength of the insurance company before you invest in an annuity.You can do this by checking out a rating agency, such as A. M. Best. They are considered to be the industry standard for measuring the financial integrity of insurance companies. They issue ratings on more than 3,500 insurance companies worldwide. They issue ratings on insurance companies that range from a high of A++ to a low of F.If you invest with insurance companies that are at the higher end of the rating scale, the likelihood of company failure will be even lower.In addition, most states do have guaranty associations that will provide protection on annuities, typically up to a limit of $100,000 per annuity contract. You can check with your state insurance commissioner to determine if your state has a guaranty association, and what the limit of coverage is. If the dollar amount of annuities that you hold exceed that limit, then you will want to spread your annuity contracts across several different insurance companies.The Risks of Variable AnnuitiesWhile variable annuities offer definite benefits, there are also risks associated with them. Some are general risks that apply to all annuities, but others are specific to variable annuities.Surrender charges. In the event that you decide to terminate your annuity early – as in before the surrender period expires – your account will be subject to a surrender charge. This charge will vary from one insurance company to another, and even between annuities within the same company. But the company could set the charge at 4% or 5% of the amount of the withdrawal. This charge may limit your ability to change the annuities or insurance companies after-the-fact.Early withdrawal penalty. It’s not just the insurance company that will charge you a fee for closing out your annuity early. Since annuities are tax-deferred, your withdrawal will be subject to ordinary income tax, plus the 10% early withdrawal penalty imposed by the IRS.Death and survivorship. This is another limitation that applies to all annuities, and not just variable annuities. Once the funding phase of an annuity plan ends, and you begin taking withdrawals, the remaining balance of the annuity will revert to the insurance company upon your death. That means that it will not be available be included in your estate and passed on to your heirs. While this may not be an issue if you live for 30 years after you begin taking withdrawals, it will seriously reduce your estate should you die within a few years of retirement.High fees. Variable annuities contain a large number of fees, that have the potential to reduce your investment performance substantially. In the next section, we’ll cover the fees associated with variable annuities in some detail. But this is a disadvantage for variable annuities when compared to other investment types, and even other annuities.Variable Annuities are complicated investments. If you’re looking for the relatively simple investment plan, variable annuities won’t fit the bill. Though they have a number of benefits, you have to be careful when investing in them. For example, a variable annuity may contain between 80 and 300 sub-accounts. These accounts typically are not listed on any public exchanges, and little information will be available about them, other than that which is provided by the insurance company itself. Coming up with the right mix of sub-accounts can be a challenge all by itself.No guarantee of principal value. Much like stocks and mutual funds, your principal is at risk when you invest in variable annuities. They could rise substantially in value, but they can also lose money. There is no guarantee that your principle will remain stable or grow in value. As is the case with any equity based investment, if the general market performs poorly, your sub-accounts and your variable annuity will do the same.The death benefit and income accounts aren’t permanent. The insurance company could reduce or remove the death or income riders for new policies. They may also attempt to change existing policies, if possible. Under certain circumstances, the company might even offer a lump sum as an incentive to eliminate guarantees made when the annuity was first established.No truly fixed rate investment option. Some insurance companies may offer a money market fund within an annuity, but not all do. And few offer anything that looks like a real fixed rate investment. That means that your plan must be 100% invested in the market at all times.Variable Annuity FeesThe fee structure within variable annuities is higher than it is with most other investment types, and even many other types of annuities. The national average for variable annuity fees is 3.61%, however it can be substantially higher than that on any given variable annuity plan. What makes it even more problematic is that the fees are not always obvious within the plan. They can be pretty well hidden, which means you’ll hardly ever see them listed on your statement.Here are a list of fees commonly found in variable annuities:Mortality and expense risk charge (“M&E”). This expense represents compensation for the insurance company for the insurance risks that it takes on under an annuity contract. The fee also helps to pay for the insurance company’s cost of marketing variable annuities, including commissions paid to financial advisors and insurance agents. It is typically in the neighborhood of 1.25% of the value of your annuity plan.Administrative fees. The insurance company may charge these for administrative tasks, such as recordkeeping and reporting. It’s a small amount, and usually a flat fee ($25 to $50) is charged on an annual basis. But with some annuity contracts it can also be a fee charged on a percentage basis, typically 0.15% of the value of your annuity contract.Underlying fund expenses (for sub-accounts). These are similar to the investment expenses (12b-1 expenses) charged within mutual funds, except that they are charges of the sub-accounts.Additional riders. These are fees associated with riders that can be attached to a variable annuity. They can be for the cost of adding a guaranteed minimum income benefit, long-term care insurance, or a stepped-up death benefit.Surrender charges. We discussed these earlier, and they can be assessed if you decide to take a withdrawal from your annuity, or completely close it out within the surrender period. It is typically several percentage points of the value of the annuity contract, and is designed to keep you from liquidating your account early, while the plan is building up value. In many cases, the surrender charge works on a declining basis. For example, it might be equal to 6% if you withdraw funds within the first three years, then fall 4% for the next three years, and then 2% for the next four years.Are Variable Annuities Good for You?As you can see, variable annuities are complex investment contracts. While they can work well for some people, their certainly not an investment for everyone. In order to determine if a variable annuity will work well for you, you have to be certain as to what it is you expect it to do.You may want to look into a variable annuity if any of the following situations apply to you:You’re a long-term investor. You have a very long investment horizon, stretching between now and out to the very end of your life. Not only are variable annuities long-term investments, but surrender charges make it difficult to withdraw from them within the surrender period, when you will have to pay a surrender charge in order to do so.You want professional investment management. A variable annuity is virtually a portfolio unto itself. It includes a mix of stocks and bonds, each of which is in a sub-account that is professionally managed by investment managers.A focus on retirement income. As is the case with all annuities, they are designed primarily for retirement. The long-term nature of the investment, in combination with tax deferral and a long-term income payout make it perfect for this purpose. You can invest your money in an annuity for a time, after which it automatically converts into something like a pension.You’ve maxed out your retirement contributions. If you’ve reached a point where you’ve made the maximum contributions to your IRA and/or 401(k) plans, a variable annuity can enable you to make virtually unlimited additional contributions toward your retirement. Though there is no tax deduction for the contributions themselves, the money will accumulate on a tax-deferred basis. This can be a major advantage if you have begun preparing for retirement late in life, and need to contribute more than traditional retirement plans allow.Carefully consider the benefits offered by variable annuities, as well as the risks and fees that are involved with them, to determine if they are the right investment choice for you.

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